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ABSTRACT

Since World War II, the American economy has consistently grown. However, this economic growth has been less impressive in the past 10 years, and some significant problems have developed. These include slowed economic growth, high inflation, and high unemployment. Among the major interrelated causes of these problems have been international competition, high interest rates, low savings and investment rates, and growing federal deficits. Three factors--price stability, technological capacity, and changes in the composition of the work force--suggest the potential exists to make the 1980s a period of more rapid economic growth than the 1970s. Federal policies should provide a reasonable and stable framework for private economic activity through monetary and fiscal policies. The federal government also must handle various international trade problems and stimulate research and development. The state role in stimulating economic growth and productivity encompasses activities in such areas as basic education, higher education, employment and training, transportation, other infrastructure, private-public cooperation, state business assistance policies, regulatory reform, and export promotion. (YLB)

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GOVERNORS AND NEW ECONOMIC CHALLENGES

A Background Paper

Prepared for the

75TH ANNUAL MEETING

of the

NATIONAL GOVERNORS' ASSOCIATION

July 31 - August 2
Portland, Maine

NATIONAL GOVERNORS' ASSOCIATION
OFFICE OF RESEARCH AND DEVELOPMENT

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THE GOVERNORS AND NEW ECONOMIC CHALLENGES

EXECUTIVE SUMMARY

As the governors convene for their 75th annual meeting, the United States economy is beginning its long-awaited recovery. Yet, this recovery is not likely to eliminate problems facing this country's economy, problems of high unemployment, stagnation of basic industries, and the loss of American jobs to foreign competition.

This nation – long the world's economic leader – suffered through a decade of slow growth, high inflation, and high unemployment. It saw personal savings fall and federal deficits build to mind-boggling highs. It saw our foreign competitiveness in exports erode and our market for imports expand.

Looking ahead to the rest of the 1980s, the nation faces continuing rapid economic change including a decline in manufacturing relative to service industries and information processing – a shift parallel to the earlier shift from agriculture to manufacturing. Three factors – price stability, technological capacity, and changes in the composition of the workforce – suggest the potential exists to make the 1980s a period of more rapid economic growth than the 1970s.

The nation's economic successes and failures will largely be determined by the private sector – by private invention and innovation, worker productivity, risk taking, and skill. However, government policies can have a major impact on the outcome.

The major role of the federal government should be to provide a reasonable and stable framework for private economic activity through monetary and fiscal policies, including reducing the deficit. The federal government also must handle various international trade problems and stimulate research and development to permit the economy to achieve its potential.

States have long had primary responsibility for administering programs important to development needs in education and training, transportation, water supply and treatment and other infrastructure areas. They also provide the social policies or "safety net" that makes a rapidly adjusting "lean" economy, with its frequent dislocations, acceptable to the American people. In addition, in recent years, they have taken the lead in government-business cooperative efforts to create jobs. States have brought government, labor and business together for such diverse purposes as developing statewide strategies for technological development, increasing the relevance of vocational training, and providing technical assistance and financing.

The states have been particularly active in working with small business on the theory that the preponderance of job creation will come from such firms. Assistance in new starts and expansion is being provided in a variety of forms – construction of supporting public infrastructure, financing, technical assistance, technology transfer programs, and worker training are examples. The states have proven close enough to serve the small firm, while large enough to provide the diverse programs needed to assist small business. States have used a variety of mechanisms – field offices, decentralized higher educational institutions, and field teams – to reach small firms wherever they may operate.

The state role in stimulating economic growth and productivity encompasses activities including:

- improving the quality of elementary and secondary education,
- expanding high technology capabilities in higher education,
- providing training for structurally unemployed workers,
- improving the capacity of the transportation system,
- funding public infrastructure directly tied to expansion of private productive capabilities,
- eliminating unnecessary regulation and reducing the unnecessary paperwork and delays in complying with the regulation that remains,
- investing in private firms, primarily through loans but also through selected equity investments,
- cushioning the personal hardships associated with rapid economic change with cash assistance and social services,
- providing technical assistance, concentrated on smaller business with many special programs designed to encourage high technology start-ups,
- encouraging successful exporting activities, and
- building on a foundation of private-public sector coordination and cooperation.

The diversity, quantity, and durability of these state activities suggest several conclusions. First, if adequate flexibility is allowed by federal policies, the states can serve as laboratories of democracy where policies can be tested. Second, while state policies differ in detail, state leaders have made a major commitment to strengthening the U.S. economy through growth in the private sector.

The nation's governors have a major role to play in meeting the new economic challenges facing this nation. Working with the federal government and the private sector, they can help restore strength and vitality to the national economy and assist in ensuring long-term economic growth. In their 75th meeting, the governors will lay the groundwork for that effort.

PROBLEMS IN THE ECONOMY

Except for temporary pauses associated with recession, the American economy has consistently grown since World War II. However, this economic growth has been less impressive in the past ten years than in earlier periods and some significant problems have developed during the decade. These include slowed economic growth, high inflation, and high unemployment.

Slower Growth. Since every year we have more people wanting to share our national output, the American economy has to grow just to stand still. Moreover, Americans do not want to stand still. They want more real output to provide for a steadily increasing standard of living and for expansion of various public programs ranging from police protection to national defense. However, the real (inflation-adjusted) rate of growth in our economy has been dropping. Table 1 shows the growth in gross national product (GNP) in real and per capita terms in three ten year periods.

Table 1: Annual Growth Rates in Real GNP and Population
(Percentage Change)

	1952-62	1962-72	1972-82
Real (inflation-adjusted) GNP	2.9	4.0	2.2
Population	1.7	1.2	1.0
Real Per Capita GNP	1.2	2.8	1.2

Table 1 shows that real GNP has grown in each ten year period, but substantially less in the last ten years than in the earlier periods. After adjusting for population growth, the GNP gain in the past ten years was only half as great as in the preceding ten. Of particular concern is the slow productivity improvement in the second half of this period.

Much of the growth that has occurred in our economy has resulted from more people working, rather than increasing productivity. The percentage of persons 16 and older in the labor force has grown from under 60% in 1960 to about 64%. This expansion has occurred primarily because of greater labor force participation by women. In 1960 about 38% of women 16 and older were in the labor force, but today the rate is over 52%. In effect, we are showing economic growth by more people working, not necessarily by working more productively.

Productivity growth is important both to keep our goods competitive in price and quality with those of other nations and to raise our standard of living. The nation can afford higher individual living standards and improved services from government if output per worker can be improved. The faster the gain in output per worker, the greater the improvement in national living standards.

While measurement is tricky, available evidence suggests that we have been doing a poor job of increasing productivity. A recent report by the Committee for Economic Development indicates that total factor productivity in private business grew by 2.6% a year from 1948 to 1963, but that the growth rate dropped to 1.8% in 1965-73, to 0.4% in

the 1973-1979 period, and was negative in 1979-1981. Comparsions of national productivity by the Bureau of Labor Statistics suggest that the United States has been lagging behind other major industrial nations in productivity growth.

High Inflation. The 1970s saw the coining of a new term, "stagflation," to characterize the combination of slow growth and high inflation. Inflation was high throughout the decade by historical standards, in some years reaching double digit rates. Table 2 compares ten-year periods using two measures of inflation: the Consumer Price Index (CPI) for consumer purchases and the GNP deflator for consumer, business, and government purchases combined.

Table 2: Annual Rates of Change in Price Levels
(Percentage Change)

	1952-62	1962-72	1972-82
GNP Deflator	2.0	3.5	7.6
CPI	1.3	3.3	8.7

By either measure, the inflation rate from 1972 to 1982 was more than double that of the preceding ten years.

Two major price shocks contributed heavily to this inflation – high interest rates and sharp oil price increases. Saudi Arabian light crude benchmark prices jumped from $1.35 a barrel in 1970 to over $10 in 1975 and to about $30 now. These increases caused price ripples in other energy sources and major readjustments in consumption patterns. Inflation tended to push interest rates higher and higher interest rates increased the costs of homeownership and business financing, thereby causing increases in the Consumer Price Index.

A high and uncertain inflation rate has many negative effects. It can encourage investments in presumed inflation hedges such as rare stamps and coins, rather than in productive capacity. It tends to produce high nominal interest rates, which reduce the value of investments in bonds made when interest rates were lower. Because different people have different inflation hedges, inflation changes their economic relationships. For example, in the 1970s, persons dependent on private pensions and personal savings lost ground relative to those reliant on Social Security and to those whose wages were indexed to the inflation rate. High inflation also introduced uncertainty into many economic decisions, ranging from personal investment decisions to business decisions on whether to invest in new plants and equipment.

High Unemployment. High unemployment is doubly tragic for the nation. For the affected individuals, it means major economic adjustments such as losing one's home, psychological stresses, and a failure of the American dream. For the nation, it means a loss of output. If the nation has labor and plants that are not being used, national output can be improved dramatically just by using them. In March, 30% of manufacturing capacity was unused and 10.8% of the workforce was unemployed.

The current unemployment rate is very high by historical standards. From 1977 to 1980, unemployment never exceeded 7% of the labor force. From 1962 to 1974 the unemployment rate didn't exceed 6%, and in the recession year of 1975 the unemployment rate of 8.5% was over 2% below the current unemployment rate.

The current unemployment is also very unevenly distributed. The rate for black workers is nearly twice as high as for white workers and teenagers have much higher unemployment than adults. Some regions and states are harder hit than others. In March, unemployment was over 20% in West Virginia and 17% in Michigan, but ten states had rates below 8%. Hardship was also unevenly distributed by industry, with high concentrations of unemployment in steel, autos, and coal mining.

ANALYSIS AND CAUSES OF ECONOMIC PROBLEMS

The problems of slow growth, high inflation, and high unemployment had a number of interrelated causes. In addition, each of these problems contributed to the severity of the others. Among the major causes of these problems were international competition, high interest rates, low savings and investment rates, and growing federal deficits.

International Competition. The 1970s saw rapid growth in the economies of Japan and Western Europe as well as such countries as Korea, Brazil, and Taiwan. This growth has made these countries major factors in U.S. domestic markets and provided stiff competition for U.S. companies attempting to export. As a result import competition has become much stronger, as any buyer of clothes, cars, and electronic products knows. Imports grew from 13% of total manufacturing production in 1972 to 21% in 1981. Fortunately, the increasing penetration of imports in our economy has been matched by an increasing percentage of our production being sold to other countries.

Our competitiveness in exports and in our own markets has been damaged by what many view as the surprising strength of the American dollar in relation to key foreign currencies. Normally, currency fluctuations tend to offset trade imbalances as countries that export more than they import find their currency values increase, making exports harder to sell and imports more attractive for domestic consumers. However, for a variety of reasons (e.g., preferences by Arab investors for dollar-denominated investments), the value of the dollar in recent years has remained surprisingly high – much stronger vis-a-vis the Japanese yen than in the late 1970s, more than a third stronger relative to the Italian lira than in 1977.

High Interest Rates. The last ten years also were a period of generally high interest rates by historical standards. Table 3 shows some typical rates in various years.

Table 3: Nominal Interest Rates for Various Securities

	1962	1972	1977	1982
High Grade Municipals (S&P)	3.2	5.3	5.6	11.6
Corporate AAA (Moody's)	4.3	7.2	8.0	13.8

To encourage savings, interest rates need to be high enough to compensate lendors for loss of purchasing power due to inflation plus provide some "real" return over and above what would simply offset inflation. The higher the expected inflation rate, the higher interest rates will be. Unexpected high inflation in the 1970s meant that the real rate of interest was often negative, that investors would have been better off by putting their money into real assets (e.g., land and commodities) than by purchasing stocks and bonds or putting funds into savings accounts. Concern that inflation will return to high rates has caused investors today to insist on high yields for long term investments, making

the real interest rate on the order of 6%: 11-13% rates minus 5-7% inflation, triple historical real interest rates.

High interest rates deterred consumers from making home and car purchases that are typically financed by borrowing and tended to discourage business investment in new plants and equipment.

Low Savings and Investment Rates. In the 1970s, Americans saved a significantly lower percentage of their incomes than citizens of other industrialized countries. Although cross-national comparisons are difficult, it would appear that the Japanese saved three times as large a proportion of their personal incomes as Americans during the 1970s and that residents of several European nations saved twice as large a percentage of their personal incomes as we did. Low savings rates reduce the pool of money available for business investments, for construction of public infrastructure using bond issues, and for financing the federal debt. As users compete to borrow a small pool of saved funds, interest rates tend to rise.

One way productivity, and thus national output, can be improved is by investment in more efficient plants and equipment. The Committee for Economic Development reports that capital investment as a percentage of output was less than 10% in the United States from 1970 to 1977 while it was just over 15% in West Germany and Canada and 26.5% in Japan.

Federal Deficits. The federal government spent more than its revenues every year during the 1970s. In 1981, the Congress adopted phased tax cuts and patterns of spending that, combined with other built-in spending increases, created a "structural deficit." This deficit, even with recovery from recession, is expected to be on the order of $200-300 billion a year, a massive amount. To finance a deficit of this magnitude, every year every American worker would have to save $2,000 to $3,000 and loan all of it to the federal government.

A deficit this large makes the federal government a competitor of private businesses that need to borrow funds for new plants, equipment, and inventory, as well as consumers seeking funds for housing and purchases of durable goods, and state and local governments needing to finance capital outlay. This magnitude of borrowing tends to increase interest rates and to depress both investment and consumption, thereby becoming a drag on economic growth.

The American economic outlook for the remainder of the decade is uncertain. However, the nation's situation has many positive aspects and only a few negative ones. Whether the economy performs better in the 1980s than it did in the 1970s will be partly determined by how well government policies mitigate the effects of less favorable influences as well as how well those policies exploit the favorable aspects of our current situation.

Our economy has been undergoing major structural changes as important as the dramatic shift of labor from farming to manufacturing that took place earlier in our history. New employment opportunities are developing in the service sector, where productivity growth is relatively slow. Advances in information technology have resulted in new job opportunities in computers, data base management, programming, and related skills. At the same time, manufacturing employment has been relatively stable. Current employment in manufacturing, partly influenced by the recession, is under 19 million jobs. However, the 21 million manufacturing employees in 1979, the highest year for manufacturing jobs, was only slightly above the 20.1 million employed in manufacturing in 1969. Higher productivity growth in manufacturing than in service industries has allowed about the same number of manufacturing workers to serve an expanding and more affluent population.

The shift away from manufacturing as a major source of employment growth is creating some significant dislocations as many of the workers who lost their manufacturing jobs in the recession may find that they are never reemployed in the types of high wage jobs that they lost. Changes in technology and taste reduce, for example, the demand for steel output at the same time that investments are being made to reduce the labor needed to produce that output.

While there are inherently serious dislocations in this type of economic change, the changes also bring useful results. Like the transition from an agricultural economy, the transition from a manufacturing economy will see the creation of new job opportunities in many fields. As the economy shifted from agriculture, the United States became the world leader in manufacturing. Yet agricultural productivity allowed the nation to remain self-sufficient in agricultural production and to be a major exporter of agricultural products. The challenge in the decade of the 1980s will be for the United States to lead in new technologies much as it led in manufacturing while maintaining a manufacturing sector as strong as our agricultural one.

The United States has many economic assets with which to deal with the international economic competition of the 1980s. The nation is rich in energy resources compared with Europe and Japan; we have political stability unmatched in the world; we have highly efficient agriculture and are self-sufficient in such important commodities as timber. Furthermore, our high reliance on the private sector means that we have institutions that can accommodate rapid technological change.

The condition of our private and public infrastructure is both one of the nation's greatest assets and a cause of considerable concern. We have some of the finest public infrastructure in the world, including school buildings with more capacity in relation to school age students than other nations, enough university capacity to handle expected enrollments, and an excellent inland transportation system for both water and ground transportation. Our private infrastructure includes some of the best scientific equipment in the world. As factory utilization rates suggest, we currently could increase production

in many industries substantially using current capacity alone. We have immense capacity for the generation of electric power, more than currently required, and highly reliable systems for the distribution of electric power, natural gas, and water. Our privately owned trucks and rail system are difficult to match anywhere in the world for sheer capacity to carry large quantities of goods.

However, there are weaknesses in our private and public infrastructure. In public infrastructure, some of our past investments (e.g., highways) require maintenance and restoration to retain their usefulness. In many cases, we have created infrastructure deficiencies by raising standards above past levels, as is the case for bridge widths, road lane widths, tertiary wastewater treatment, and housing prisoners. In other cases, massive population shifts create demands for new public infrastructure, including very expensive needs for transportation and water supply facilities in the Southwest. In other cases, such as water supply in the East, past investments are reaching the end of their useful lives and will require substantial outlays for renovation or replacement.

The main difficulty with our private infrastructure is its age and obsolescence. Because the United States' basic industrial capacity grew well ahead of Europe's, Japan's and that of the developing countries, much of their plants and equipment are newer than ours and embody more recent technology and lower operating costs.

One persistent problem affecting our growth prospects is the high value of the dollar in relation to other currencies. Our current negative trade balance should correct this situation, but currency value relationships are affected by factors other than exports and imports. One of the other important factors is the international movement of money. Because of our political stability and high interest rates, the United States has proven to be a popular place for the short and long term investments of other governments and foreign nationals.

As we look ahead to the rest of the 1980s, three factors are particularly important to the nation's economic future: (1) price stability, (2) technological capacity, and (3) demographic changes.

Price Stability. Indicators over the last two years would suggest that inflation has been brought under control, although the inflationary impacts of continuing large federal deficits remain a concern. Continued price stability could bring a number of benefits to the American economy, including improved competitiveness with other nations and a decline in long-term interest rates as investors become convinced that double digit inflation will not return. Lower interest rates will encourage consumer purchases and improve the economics of business investment.

It seems very unlikely that the sharp oil price increases of the 1970s will be repeated. The price of oil is now at a level where further sharp increases would promote wholesale shifts to other energy sources, particularly coal.

Price stability itself, and the expectation of continued price stability, is a very favorable factor for economic growth. Price instability can discourage investments, encourage financial transactions with no real economic substance, and generally promote an atmosphere of uncertainty.

Technological Capacity. In the midst of concern over problems with industrial obsolescence and inadequacies in our educational system, it is easy to forget how substantial the American technological base is.

Much of our workforce is mechanically quite sophisticated, with capabilities such as the use of power tools, the ability to drive trucks and to repair engines. While the educational achievements of our population are not as great as many believe they should be, our long tradition of emphasis on education for everyone means that on average, our citizens have had more formal schooling than persons in most other countries of the world. While not everyone in the United States is comfortable with new technologies, a significant part of our population has taken up automated data processing as a hobby and many of our clerks now use computerized data links, word processors, and other new technologies as part of their day-to-day routine.

The United States maintains its lead in many technological fields ranging from genetics to instrumentation and the country has a strong research base in its universities, government laboratories, and private sector. The size and technical sophistication of our economy means that specialized products (e.g., silicon chips for specialized uses) can be procured with relatively short lead times for a variety of uses.

Much of the economic challenge for the United States is to translate our current "state of the art" into the "state of the practice" in our factories and offices. While this will require considerable capital and some difficult adjustments, it is something that, as a nation, we know how to do about as well as anyone.

Demographic Changes. During the 1970s, the American workforce increased dramatically because of the infusion of large numbers of youth and because of a sharp increase in the percentage of women who work. Some observers attribute higher unemployment and slower productivity growth, in part, to these demographic changes. The decade of the 1980s will see lower workforce growth from these causes.

This means that a higher percentage of our workforce will be those experienced in their jobs, rather than those needing to be taught introductory work skills. One result should be the opportunity for greater productivity growth.

As this inventory suggests, the United States can face the competitive international environment of the 1980s with substantial national assets. While there are problems, none appears insurmountable. However, the new economic environment will bring major changes in how we produce as well as what we produce. Of course, the most powerful change agents will be found in the private sector, from large corporations to those pioneering with new products in small firms. But government has a major role as a force that can facilitate change (or stifle it) and cushion the inevitable losses that accompany changes.

ACHIEVING AMERICAN ECONOMIC RESURGENCE: FEDERAL AND STATE POLICIES

As they meet this summer, the governors will be discussing the economic challenge facing the United States and federal and state policies designed to promote economic growth. This section summarizes some of the state and federal policies to be discussed.

FEDERAL POLICIES

For state policies relating to economic growth to have any significant effects, there must be an appropriate national climate. Thus, the governors have a natural interest in national policies that bring the nation smoothly out of recession and that provide a reasonable basis for competition in the international marketplace.

Industrial Policy. Recently there has been considerable discussion of "new industrial policy" and the need for national policy machinery to deal with policies affecting particular sectors. The governors' current policy on this subject was adopted in 1980:

> The United States, unlike many industrial nations, does not have a formal national sectoral or industrial policy other than for agriculture. Policies to preserve key industries generally have been undertaken on an ad hoc basis, usually in response to perceived threats from foreign competition or sudden declines due to changing technology. However, structural shifts in domestic and world markets have created a need for a more conscious and deliberate approach to preserving and to promoting growth of key sectors of the economy.
>
> The formulation of a national sectoral policy should be undertaken in the context of overall economic goals of reducing inflation and unemployment and increasing economic growth. Sectoral policies must be consistent with the objectives of balanced national growth and economic development, and should be designed to promote the goals of economic efficiency and equity. Priority consideration must be given to preserving industries that are vital to our national security. However, the major focus of a national sectoral policy should be on easing problems of transition in declining industries and promoting growth and expansion of newer, more productive sectors of the economy.
>
> These goals can be achieved without detailed federal legislation. However, a national framework for cooperation between government and the private sector must be established to focus on the problems and opportunities that exist in specific industries and sectors of our economy. To ensure that the effects of industrial growth and decline on state and regional economies are given adequate consideration within this national framework, governors should be full partners in the government-business-labor consultation process and should play an active role in the formulation of national sectoral policies.

Recession and Recovery. While the economic situation is improving, continuing problems exist. Unemployment is in double digits and the real gross national product in the first quarter of 1983 (seasonally adjusted annual rates) is below what it was in 1981. In their February meeting, the governors expressed their concern that sustained substantial deficits could erode the recovery. The governors urged the Congress to reduce the 1988 deficit to approximately 2% of GNP using a combination of expenditure and revenue changes.

The strength and duration of recovery will also depend upon the ability of the federal government to pursue monetary policy that provides enough room for growth without threatening price stability.

International Trade. While the prime determinant of the success of U.S. firms in international trade will be actions of firms and their workers, federal government policies can have an effect on their success. Policies potentially affecting international competitiveness include export controls, non-tariff barriers to trade, extraterritorial application of certain U.S. rules to U.S. firms operating abroad, foreign government export financing practices, hidden export subsidies for firms owned by foreign governments, and differential treatment of taxes under the General Agreement on Trade and Tariffs.

Research and Development. Some types of research and development confer benefits that can be captured in the private sector, as is the case with patentable inventions. In such cases, the work is typically conducted at private expense, with the main public policy question being one of the extent of tax policy concessions to encourage research and development. However, some research and development does not fit this classification because it is inherently public sector oriented (e.g., improved fire supression techniques), provides basic non-patentable discoveries (e.g., particle research), or has costs out of line with potential private rewards (e.g., accelerators for nuclear particles on space exploration). In these cases, particularly in basic research, public sector research sponsorship is appropriate and, because benefits are nationwide, federal rather than state and local sponsorship is appropriate. The key question is whether the combination of federally sponsored research and development and federal inducements for private research and development are adequate to maintain (or retain) competitive advantages for U.S. technology.

STATE ROLES AND POLICIES

The Increasing Role of States. While governments at all levels will have responsibilities in bringing about an American economic resurgence, a number of factors have already caused states to play increasingly important roles in dealing with the American economy.

One circumstance that has led to this emphasis on state and local government is the federal fiscal situation, which leaves little room for new federal initiatives for promoting economic growth and has resulted in the cutback of federal funding for economic development. Until the threat to the national economy from large deficits is removed, new federal spending in the name of improving American productivity or ability to compete might choke recovery by swelling the deficit, pushing interest rates upward, and discouraging new private investment. While the states currently have cyclical fiscal problems, they have no counterpart to the federal "structural deficit." With exceptions, state revenues from existing taxes are sufficient, in non-recessionary periods, to cover the costs of continuing current state policies with no deficit.

Besides fiscal constraints, there is increasingly widespread recognition that the national government may not be the "government of choice" for financing, managing, and implementing public policies. With no need to follow federally dictated policies, states are free to experiment with various policies and to tailor policies to their individual local circumstances.

There has also been a substantial shift in financial responsibility from local to state governments. In 1929, local government spending financed by local resources was more than twice that of state governments. However, increasing concern over problems best handled by states (e.g., statewide road networks, large institutions for the mentally ill and criminal offenders, and provision of higher education) and the need for state action to mitigate fiscal disparities among local governments caused the state share of self-financed spending to begin to exceed the local share in the mid-1960s.

One result of these state responses was that state expenditures from "own source revenue" rose from half the state-local total to 54.5% in 1982, as estimated by the Advisory Commission on Intergovernmental Relations. When one examines tax revenue (which unlike local revenue excludes user charges such as payments to municipal gas and electric utilities), the state role and its increase are even more obvious. State governments in 1981 raised 61.6% of all tax revenue raised by state and local government, up from under 50% 20 years before.

The states have proven particularly adept at devising private-public cooperative ventures tailored to the specific needs and potential of individual states. There are many examples of such cooperation in areas as diverse as teams working for economic development, studies of business climate, strategies for technological progress, and joint efforts to improve the quality and relevance of education.

Because the states are decentralized, they are well suited for working with the millions of small businesspeople who will be the source of much of the new job generation and technical innovation likely to take place in the United States. Through field teams, higher education systems and decentralized offices, the states work with these entrepreneurs by providing technical assistance, financing, worker training and other services.

Traditional and Newer State Roles. State governments play an important role in any national policy oriented toward economic development because of the importance of their traditional concerns to development needs. These traditional concerns include:

- human capital programs
  - elementary and secondary education
  - higher education
  - adult education
- physical capital programs
  - highways
  - water supply and wastewater treatment

States also have newer roles in economic growth, some related to federal programs and some not. Examples are:

- manpower programs
  - training
  - placement
- regulatory reform
- physical capital
  - site-specific infrastructure (roads, shell buildings)
  - solid waste disposal
  - rail and transit investments
  - port development
- business assistance
  - export promotion
  - new business start-ups
  - technical assistance
  - financing
  - management training

It should be remembered that much of what state governments do is not directly oriented toward economic development, but provides the social policies or "safety net" that makes a rapidly adjusting "lean" economy, with its frequent dislocations, acceptable to the American people. Most significant financially are the federal-state programs that provide cash assistance, food, and medical care to those in need. These programs include AFDC, state and local general assistance programs, unemployment compensation, Medicaid, and food stamps. In addition, states provide a variety of social services for those suffering from economic misfortune.

Basic Education. The states bear more of the costs of elementary and secondary education than any other level of government and are expected to continue to increase their share. They also accept responsibility for minimum standards including certification of teachers, statewide competency testing, and requirements such as those governing the length of the school year. There is considerable evidence that the quality of basic education in this country is declining and significantly below that of many countries with which we compete. Education is also closely related to economic growth. Details on these points will be found in materials such as the report of the national Task Force on Education for Economic Growth chaired by North Carolina Governor James B. Hunt, Jr.

In elementary and secondary education, the federal government has placed its attention primarily upon providing funding to stimulate equal opportunities in education. States have assumed responsibility for funding minimum or "foundation" programs and for educational quality issues. However, typical state practice is to rely on local education agencies for much of the leadership in determining how quality will be provided, using the state primarily to enforce minimum standards and conduct those activities (e.g., statewide testing) that must be performed by a state agency. The recommendations made by many different groups call for state actions such as simultaneously raising competency required for public university admission and for high school graduation, increasing the length of the school day and/or year, establishing merit teacher programs, rewarding outstanding performance of teachers and maintaining high certification standards, and doing a better job of fighting the dropout problem. Many of the governors have already taken leadership in their states in these fields.

As a result, 37 states now have some form of minimum competence testing of students; and many states have tightened their requirements for admission to and/or graduation from teacher training programs, increased teacher training opportunities, provided special incentives to increase the supply or math and science teachers, and revised curricula to place more emphasis on basic skills. North Carolina has established a special state school for gifted students and many states are experimenting with policies to reward particularly competent teachers.

Higher Education. Since World War II the states have, with limited help from local and federal governments, provided massively improved opportunities for persons to obtain low cost, high quality higher education. As a result, our higher educational system provides more open opportunities and serves a larger percentage of the population than higher education systems in other industrialized countries. While the federal government will presumably continue to promote access to this system by the disadvantaged through Pell Grants and other programs and continue to have some research performed in public (and private) higher educational institutions, the primary responsibility for continuing higher educational support and for linking it closely with needs for economic growth will continue to fall on states.

This state government-university-private sector linkage to promote economic development, particularly in high technology fields, is becoming increasingly popular. States are doing such things as creating new institutes (e.g., in North Carolina and Michigan), establishing consortiums of private and public universities (e.g., the Utah Energy Consortium), endowing special chairs in high technology fields, and promoting public-private sharing of personnel and equipment in order to bring the best technologies into both the classroom and the workplace.

Employment and Training. The states have major roles beyond education in training for employment and in matching potential employers and employees. Part of this work is handled in state education systems, including vocational and adult education and continuing education. Part is handled through the state employment services offices that administer the unemployment compensation system and seek to place persons eligible for unemployment compensation. Part of this responsibility will stem from the new federal Job Training Partnership Act. This legislation, which becomes effective this October, emphasizes a partnership between government and the private sector and is oriented to private, rather than public, sector employment.

Under this legislation, state officials designate service delivery areas within the state and establish private industry councils for the administration of programs in each area. States have the opportunity to use this program as one mechanism for public-

private partnerships and to tie it in various ways to other state programs ranging from income maintenance to vocational rehabilitation. In addition, such programs can be directly linked to job training programs designed to meet the needs of new employers. Examples of such programs include the "Special Schools" program in South Carolina, "New Jobs" in Minnesota, "Profit-Train" in Texas, and similar programs in Michigan and Pennsylvania.

States are already experimenting with a variety of other approaches including educational vouchers for unemployed workers in Delaware, various programs to provide jobs for welfare recipients, and programs modeled on the Massachusetts Bay State Skills Corporation. Some of these programs are designed with a private sector match, both to reduce state financial commitments and to ensure that the training being provided is closely tied to what the private sector perceives as being required. Some states have special programs for workers who have lost their jobs due to layoffs or plant shutdowns including special retraining assistance and free tuition at community colleges. California has used special economic adjustment terms to coordinate assistance of state and private agencies to such workers.

A wide variety of experimentation is taking place in programs for youth employment. Some states have developed programs modeled upon the Civilian Conservation Corps – a federal program active during the depression. There are business-government partnerships for youth placement in Delaware and in many major cities. Several states are beginning demonstration projects under the auspices of public/private ventures using a combination of foundation and state funds.

This experimentation offers considerable hope that the states will find ways to surmount the compartmentalization of programs, aided and abetted by narrow federal categorical funding, that has hindered training and employment efforts for some years. States already expend substantial resources on transfer payments to persons not working (welfare, unemployment compensation, workers' compensation), already have massive training capabilities (elementary and secondary education, community colleges, four year colleges and universities), and placement capabilities (employment services plus special placement associated with the educational system, vocational rehabilitation, drug and alcohol rehabilitation and other special programs). Much of the experimentation is taking place on the assumption that more effective use of resources, rather than massive infusion of new resources, may be the answer to economic growth needs related to employment and training.

Transportation. An efficient internal transportation system is a key to the competitiveness of any country in the world economy. States administer the interstate highways and other major highway systems and have primary financial responsibility for their repair and maintenance. Typically, states also have their own highways, not part of a federally aided system, and provide support for local government for the maintenance of roads and streets. Some states are also involved in rail transportation of both goods and people, are participating in the financing of waterways, make outlays for ports and terminals, and assist local governments in funding mass transit.

Other Infrastructure. Most non-transportation infrastructure provided by states is incidential to performance of functions (e.g., building schools, mental hospitals, and correctional institutions) not directly related to the competitiveness of private producers. However, there are several key areas, such as water supply and local wastewater treatment, where states have become involved both in the policies involved and in financing. Several states (e.g., Alabama and New Jersey) use state funds to assist local governments in meeting infrastructure needs associated with location or expansion of

industry. New York and New Jersey are planning to use the resources of the New York Port Authority for development projects and an infrastructure bank is being considered in New Jersey.

Private-Public Cooperation. While there has been some discussion of formal ties between the federal government and industries and firms in a "new industrial policy," federal policy affecting an industry or firm generally grows from a number of ad hoc decisions in fields ranging from tariff policy to pollution control. The policy is often adopted in an adversarial context. As might be expected, this style of policy development can be seen in state decision-making as well. However, a number of state leaders and leaders of firms have also worked together in a variety of cooperative ventures and in cooperative policy-making for economic development. Examples are use of business personnel as formal or informal state economic advisors, formal representation of the private sector in economic development and manpower policy-making boards and informal representation in developing joint private-public proposals to firms considering locating in particular areas, and private-public sponsorship of centers of excellence in state universities.

There are technology task forces, typically with private and public sector members, in California, Iowa, Kansas, Michigan, Maryland, New Jersey, North Carolina, Pennsylvania, Utah and Virginia. Many states have internal efforts underway to examine their attractiveness to business and some, such as Wisconsin, have more formal efforts to do the same thing.

State Business Assistance Policies. All states have aggressive policies to promote economic development in order to improve personal income and employment. These programs are comprehensively described in material prepared by Chemical Bank for NGA (Guide to State Capital Formation Incentives and Innovations, 1983) that deals with overall incentives and, for activities dealing with technological innovation, in a preliminary report of the NGA Task Force on Technological Innovation (State Initiatives in Technological Innovation, 1983). At the NGA annual meeting, governors will receive a state-by-state guide to business incentive programs developed by the National Association of State Development Agencies, the National Council for Urban Economic Development and the Urban Institute.

In the normal course of their business, states hold substantial assets in state pension plans and as working capital. Some states have invested part of these funds in ways designed both to promote economic development and to provide a market or near-market rate of return. Examples are the linked-deposit plan in Illinois, the Missouri Economic Development time deposit program, and pension fund investment policies in such states as Michigan and Wyoming. Some states are setting aside a portion of pension fund assets for investment as venture capital.

Some states and local governments have also established revolving loan funds to encourage business expansion. One of the best known programs is in Pennsylvania, where the state helped to finance the Volkswagen plant locating there. There are 35 different state loan programs operating in 21 states. In addition, 12 states have loan guarantee programs.

State and state-authorized local economic development incentives all are designed to have the effect of reducing costs to firms, most often to firms that serve a national or international market. The policies include tax exemptions and abatements, public provision of sites, shell buildings, and site infrastructure such as interior roads, water and sewer service, utility connections, and rail sidings, use of state credit in industrial

development and pollution control bonds, loans and loan guarantees, and technical assistance. Considered as a national policy, these actions reduce the costs of production in the United States to the firms involved and thereby increase the competitiveness of firms that locate their production in the United States.

While states typically do not make equity investments except in pension plan portfolios, some form of equity investment programs exists in ten states. Two well-known examples are the Massachusetts Technical Development Corporation and the Connecticut Product Development Corporation. Some states have also encouraged the formation of private capital pools for venture capital investments.

Regulatory Reform. Practically every state has made special efforts to deal with possible unnecessary regulatory burdens – situations where the level of regulation is excessive in relation to the benefits achieved, where regulation restricts rather than promotes competition, and where regulatory processes can be simplified and speeded up without affecting the value of the regulation.

Many states systematically review the need for regulatory agencies through sunset legislation, which causes the legislature to have to reenact authorizing legislation if agencies are to continue to exist. The budget process is also used to review whether regulatory activities are needed and such reviews often convince governors to recommend that some be ended, as was the case in Michigan this year.

Some states have established special executive branch procedures to review proposed new regulations as well as to examine the need for continuing existing regulations. California's Office of Administrative Law is a good example as are the regulatory review procedures in Pennsylvania and procedures recently adopted in Virginia.

Ten states (Alaska, California, Colorado, Michigan, Minnesota, New Jersey, New York, Oregon, Washington, and Wisconsin) have offices that are concerned both with eliminating unnecessary regulation and making it easier for business to deal with regulations that are retained. For example, in New York a computer system lists, for each type of new business, all of the state permit requirements. In Colorado and a number of other states, single forms are used to comply with the requirements of various different agencies as part of a move toward "one stop shopping" to simplify business burdens associated with complying with state regulations.

Export Promotion. The states have also become involved in promoting exports of both raw materials and manufactured products. A significant number of states have export promotion offices abroad and states participate in trade shows and various types of private-public sales trips abroad. These programs are described in the NGA publication Export Development and Foreign Investment: The Role of the State and Its Linkage to Federal Action, 1981. (For a book length treatment, see State Government Influence in U.S. International Economic Policy, 1983.) Concerns over unfair competition have caused serious discussion of state provision of export financing and state purchasing policies designed to retaliate against producers of countries seen as competing unfairly in international markets.

CONCLUSION: THE GOVERNORS AND ECONOMIC DEVELOPMENT

For decades, the governors have argued for increasing the amount of flexibility accorded state and local officials in administering federally funded programs. Their basic argument is that situations differ among the 50 states, so that different policies and priorities are appropriate, and there should be room for state-by-state variations. For example, states in the Midwest and Mid-Atlantic have large numbers of displaced blue collar production workers, many of whom are in their forties and fifties and not particularly mobile. These workers have quite different needs from the more mobile younger workers who have lost jobs as a result of cutbacks of oil shale projects and lumbering in the West and reductions in oil drilling in the Southwest. Furthermore, some states do not have significant numbers of displaced workers at all. Thus, unless federal programs tolerate diversity, federal funds used under uniform rules are not likely to be used optimally in many individual situations.

Diversity has another important virtue – using the laboratories of the 50 states as a basis for experimentation. While each observer has his or her own list of programs that have not worked well, it is clear that some of our federally funded, state-administered programs have not worked to everyone's satisfaction. Examples are welfare programs that have not succeeded in moving persons into employment, health care programs for welfare recipients with spiraling costs, and a variety of job training programs that have not led to enough placements in permanent meaningful jobs to satisfy those taking the training or those paying for it. While there is considerable room for further reductions in federally imposed restrictions on state experimentation, the new manpower program and new rules in such programs as AFDC and Medicaid have given states the opportunity to experiment.

States are also experimenting in a variety of areas where federal funding is not a major factor and, in some, not a factor at all. Examples are numerous, including state programs to promote transfer of technology from universities to business, state export promotion programs, industrial incubators, new ways to enrich instruction in the early grades, mechanisms to improve teacher competence, and various technical assistance and financial assistance programs for business.

No one contends that all this experimentation will be successful, if success is defined as designing and implementing policies that will be adopted by a significant percentage of the states and/or the federal government. But this is not the only purpose of experimentation which, in science or government, allows things to be tried on a small scale to learn what works and what doesn't. Meanwhile, one thing is being proved. Given freedom to innovate, state and local officials and the private sector will find ways to cooperate and to use the unique resources that each brings to a national objective of enhanced economic growth. To encourage these diverse innovations does not require federal initiative, it simply requires that the federal government refrain from dictating particular approaches to problems, in effect remaining neutral on the selection of best approaches to achieving particular national objectives.

As the governors meet in August, concerns over bringing the nation out of recession will still seem paramount – particularly a monetary policy consistent with recovery and a fiscal policy oriented toward reducing the deficit. Yet, it is important that those responsible for our economy also be able to see above the peaks and troughs of the business cycle to set a course that will enable Americans to enjoy an increasing standard of living.

For the governors, this will mean background sessions on subjects ranging from technology to international trade. It will also mean consideration of national policies in cases where state government cannot reasonably be expected to take the lead. Finally, it will mean focusing on ways to enhance national competitiveness in the many areas, from education to transportation, where the policies of our states are our national policy.